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The Hidden Tax Behind Wall Street Reform

The Enterprise Value Tax would hit firms that have nothing to do with 'carried interest.'

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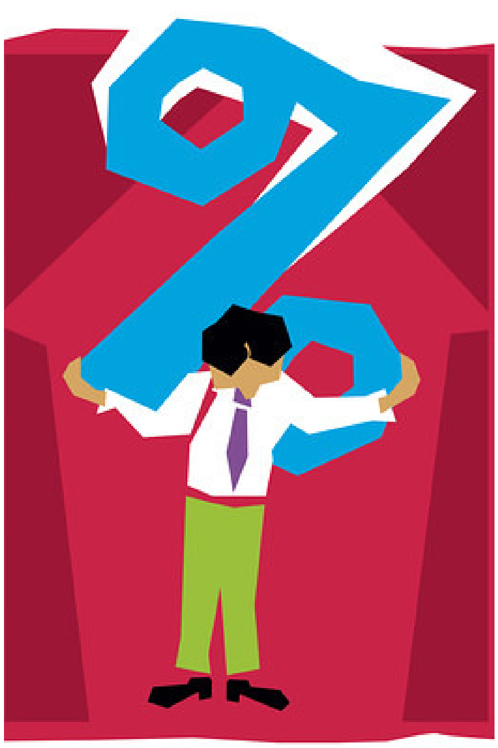
As it has in years past, Congress is now considering changing the tax rules regarding "carried interest," a kind of investment earnings often taxed at a rate lower than that of ordinary income. This matter will doubtless be resolved politically, as there is no clear right or wrong answer economically. To paraphrase Churchill, messy fighting among lobbyists, lawyers and demagogues is the worst way to settle such things, except for all the other ways.

But tied to the discussions of carried interest is another debate that, if resolved incorrectly, would mean the enactment of a pernicious and economically destructive new tax.

We are referring to the Enterprise Value Tax, which is inserted (in slightly varying forms) into the congressional proposals to "fix" carried interest and into the White House's American Jobs Act proposal. Under current law, entrepreneurs of all types who sell their companies are taxed on the profits at the capital-gains rate. The EVT seeks to change this, but only for the sale of certain businesses—namely investment-service partnerships, the sale of which would now be taxed as regular income.

The EVT is designed to claw back entrepreneurs' supposedly ill-gotten carried-interest gains from the past. But the various legislative proposals would claw back significantly more money than investment managers and other financial professionals ever saved by taking legal, proper and open advantage of the carried-interest tax treatment. (The ethics of ex post facto "clawing back" is dodgy enough, but that's a subject for another day.)



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Worse, the proposed new tax would mostly affect people who don't currently benefit much, if at all, from the tax treatment of carried interest. The savings afforded to carried interest have benefited only a small subset of investment managers who have substantial performance-fee earnings in the form of long-term capital gains. That category doesn't include many hedge funds, whose gains are mostly short-term, or traditional money managers, who don't center their businesses around performance fees.

The EVT would raise the bulk of its revenue from investment-services partnerships that have little or no carried-interest earnings, or whose carried interest is already taxed at the same rate as ordinary income because the performance fee results from ordinary income or short-term capital gains. That makes the proposed tax less a "claw back" than a pure claw.

But what about the superlow tax rates paid by investment managers and hedge funds? If these guys pay lower taxes than their secretaries, isn't some comeuppance due? The problem is that this oft-heard assertion is false.

Most investment managers—like us—generally pay ordinary income-tax rates on our earnings, which derive from fees as in any other professional partnership. This isn't to impugn privateequity or venture-capital managers who benefit from the carried-interest tax treatment; their businesses are vital to economic competitiveness. But they, and not investment partnerships in general or hedge funds in particular, are at the center of the carried-interest debate.

Then what is the real reason for the proposed new tax, and why are its advocates using the carried-interest debate as a Trojan Horse for it? Because the government needs to raise revenue, and simply changing the treatment of carried interest wouldn't raise as much. The EVT might be unfair and have little to do with carried interest, but it's where the money is. The Joint Committee on Taxation has suggested that, of the estimated $17 billion that would be generated over the next 10 years by changing the treatment of carried interest, some $8 billion-$12 billion would come from the EVT.

Also driving the EVT push is the fact that investment managers—hedge-fund managers in particular—are unpopular. Yet the tax would apply not just to hedge funds but to a much broader class of investment partnerships across industries from real estate to manufacturing. Many of these (like hedge funds) never much benefited from the treatment of carried interest. And what should popularity have to do with tax rates anyway?

The Enterprise Value Tax is a step toward selective punitive wealth taxes. Under the false cover of "fixing" the treatment of carried interest, it would tax the life's work of one group of entrepreneurs while ignoring all the rest. It would open the door to other targeted wealth taxes, a dangerous and addictive drug. If Republicans regained power, would they pursue taxes only on left-leaning filmmakers? The EVT should be stopped before it starts.

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